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SUBJECT: ROMANIA: STRONG GROWTH CONTINUES, BUT AT AN INFLATIONARY  
COST

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¶1. (U) Summary. Romania's economy posted higher-than-expected growth in the first half of 2008, prompting renewed worries of over-heating in the near future. The construction, services, industrial and retail sectors drove the growth rate to 8.8% over the same period last year. However, the impressive growth was accompanied by surging inflation, which at an annualized rate in June of 8.6% is still well above the Central Bank's target. This has prompted the Central Bank to continue its policy of monetary tightening. End summary.

¶2. (U) Romania's real GDP growth rate accelerated during the second quarter of the year to 9.3%, on top of 8.2% in the first quarter, reaching an average 8.8% growth rate over the first half (H1) of ¶2008. This was the best H1 growth performance in 18 years. The growth was driven by a surge in construction, up a staggering 33.3% over the same period in 2007; services, up 7.6%; followed by industry, up 5.8%. Agriculture improved from last year's disappointing season, when the severe drought impacted growth; H1 production this year rose by 2.6% despite floods in some parts of the country. Overall, services have risen to account for nearly half (49.5%) of GDP, while manufacturing accounts for 26.5%, construction 8.1%, and agriculture 3.6%. Statistics show robust economic expansion across the board, with household consumption increasing 11% compared to the same period in 2007. The growth in the formation of fixed capital was 7.8%. In nominal terms, Romania's H1 2008 GDP amounted to the equivalent of USD 81.9 billion.

¶3. (U) This strong growth trend has, not surprisingly, been accompanied by rapidly rising prices. Given the June-thru-June annualized 8.6% inflation rate, analysts now expect a final 2008 annual rate of between 7.5% and 8%. This would be more than double the Central Bank's target of 3.8% plus or minus 1% and a substantially worse performance than the 2007 rate of 6.6%. In H1, service sector inflation posted the highest increase at 3.78%, chiefly due to rising public utility costs. Food prices followed closely behind, up 3.68%. Only non-food items were below the average, up 3.37%. Despite several consecutive hikes of the benchmark interest rate, and high minimum reserve requirements, the Central Bank has not yet succeeded in taming inflation. Main factors in the inflation surge were higher international fuel prices, which have had a direct impact on transportation costs; persistent consumer demand, due to rising incomes; and residual tensions in the agricultural market as a result of several years of poor yields. Because one factor keeping inflation from rising even faster has been the leu's previous appreciation against the euro, worries remain with regard to the future forex rate trend. The practice of denominating (and borrowing for) big ticket purchases in

euros could drive further inflation if the leu were to markedly depreciate and the price of these goods were to rise commensurately.

¶4. (U) Despite higher-than expected inflation in the first half of 2008, initial reports for July and August indicate that a slight deceleration may have begun. Prices actually declined in August by 0.09%, prompting the August-thru-August annualized inflation rate to drop to 8.0%. Still, the main challenges for controlling inflation in the second half of the year will include real salary gains compared to labor productivity, expected growth in public sector spending during the election cycle, uncertainties related to international fuel prices, and the upward trend in government-controlled prices (i.e. utilities, transport, and social insurance expenditures). Robust economic growth and labor emigration continue to push domestic incomes higher, which in turn should continue to support retail consumption at today's high levels. However, unpredictable fuel prices will likely have the most pronounced effect on the final inflation rate for 2008.

¶5. (SBU) Comment. Despite the high inflation headlines and, in some respects, the appearance of a bubble economy, the underlying economic trends appear to be setting Romania up for a slowdown, rather than a spectacular crash. The high growth in the first half of 2008 revived old worries of a "hard landing" for the Romanian economy. However, post believes a more likely scenario is a modest slowdown in growth from the currently unsustainable 8.8% to around 5-6% in 2009. Inflation appears to have already slowed somewhat in July and August, while Romanian exports have been growing at higher rates than imports. Moreover, foreign investors' appetite for exposure to the Romanian economy remains steady, with an increasing share of the current account deficit being financed by foreign direct investment despite world financial market turmoil. Additionally, reports of layoffs, especially in the construction sector, in the weakening economies of Western Europe may eventually offer some wage relief in Romania. Large numbers of Romanian

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expatriates are employed in Spain and Italy, and if deteriorating conditions there prompt even some of these workers to return home, this would help to further moderate wage inflation. It would also assist in keeping foreign investors, who are on the lookout for investment opportunities far away from Wall Street's financial turmoil, interested in Romania. End Comment.

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